

REPORT OF EXAMINATION  
OF THE  
CALIFORNIA EARTHQUAKE AUTHORITY  
AS OF  
DECEMBER 31, 2009

Filed June 21, 2011

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San Francisco, California  
May 6, 2011

Honorable Dave Jones  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

CALIFORNIA EARTHQUAKE AUTHORITY

(hereinafter also referred to as the CEA or the Authority) at the primary location of its books and records, 801 K Street, Sacramento, California 95814.

SCOPE OF EXAMINATION

The previous examination of the CEA was made as of December 31, 2004. This examination covers the period from January 1, 2005 through December 31, 2009. The examination was conducted in accordance with the National Association of Insurance Commissioners' Financial Condition Examiners' Handbook. The Handbook requires the planning and performance of the examination to evaluate the CEA's financial condition, to identify prospective risks, and to obtain information about the CEA, including corporate governance, identification and assessment of inherent risks, and the evaluation of the system controls and procedures used to mitigate those risks. The examination also included an assessment of the principles used and the significant estimates made by management, as well as an evaluation of the overall financial statement presentation, and management's compliance with Statutory Accounting Principles and Annual Statement instructions. All accounts and activities of the CEA were considered in accordance with the risk-focused examination process.

In addition to those items specifically commented upon in this report, other phases of the CEA's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; business in force by states; loss experience; accounts and records; and sales and advertising.

## SUBSEQUENT EVENTS

### Rate Filing and New Policy Coverages

At the February 24, 2011 CEA Governing Board (Board) meeting, CEA staff recommended, and the Board approved, a rate and form application that included the following CEA policy changes:

- 12.5% decrease in the CEA's statewide average rates
- Revised rate classification plan
- Rating territory re-assignment
- New edition of each of the CEA's policy forms incorporating new coverage enhancements and refinements in coverage, definitions, and/or policy language
- Introduction of a new CEA homeowner residential earthquake insurance product offering: "Homeowners Choice"
- Introduction of a minimum premium rule for each CEA product

The targeted implementation of these changes is for policies with new or renewal effective dates of January 1, 2012, or later. Coverage enhancements would apply to all policyholders upon policy renewal and differ depending on product.

### Risk-Capital Surcharge

Safeco Insurance Company of America (Safeco) became the first insurer to become a CEA participating insurer since California Insurance Code Section (CIC) Section 10089.16(d) became law, effective July 1, 2008. Safeco submitted to the CEA policy data for its earthquake-insurance book of business, which was modeled on behalf of the CEA to calculate the likelihood and magnitude of additional CEA losses from insuring Safeco's earthquake book of business

during its first full year of CEA participation. Based on the CEA staff's report of Safeco's earthquake-insurance risk profile, on June 28, 2008, the Board unanimously approved Safeco's participation application, conditioned on Safeco's paying up to five annual capital-risk surcharges.

CIC Section 10089.16(d) states that the Board must calculate the first risk-capital surcharge one year after the date the new participating insurer first placed or renewed business into the CEA. The CEA analyzed Safeco's earthquake-insurance risk profile as of December 31, 2009, and determined that the addition of Safeco's business was more likely to produce losses, or was likely to produce greater losses, for the CEA than would a book of existing CEA business of similar size.

At its meeting on December 9, 2010, the CEA Governing Board approved the staff's calculation and approved the resulting capital-risk surcharge of \$1.7 million. The calculation was based on the increased cost to the CEA of providing claim-paying capacity (reinsurance) to insure Safeco's excess earthquake-insurance risk for that one-year period. The law allowed a participating insurer to remit the capital-risk surcharge amount to the CEA 30 days after receiving notification of its due date. As of December 31, 2010, the CEA had not received the capital-risk surcharge amount and therefore recorded the amount as a receivable on the balance sheet and as a contra-expense to ceded premiums on the income statement.

#### Capital Contribution from State Farm: 3 to 4 Unit Family Dwellings

State Farm Insurance Company (State Farm) and the CEA had been in discussions to prepare for State Farm's transfer of residential earthquake exposure of 3 to 4-unit family dwellings to the CEA and the company's writing of these CEA policies. The implementation date for State Farm to start writing CEA 3 to 4 unit family dwelling policies, new and renewal, was scheduled for policies effective September 1, 2010.

Subdivision (a) of CIC Section 10089.15 required State Farm to make an operating-capital contribution to the CEA for the transfer of earthquake risk related to the 3 to 4 unit family-

dwelling policies. The calculated operating-capital contribution was \$5,470,000, which was equal to \$1 billion multiplied by the percentage representing State Farm's residential earthquake insurance market share for 3-to-4-unit family dwelling policies as of December 31, 2008. Because State Farm's residential-earthquake-insurance market share at the time it joined the CEA was greater than 1.25%, State Farm was permitted by law to pay the operating-capital contribution either in a lump sum or in 12 equal monthly installments. State Farm elected to pay the capital contribution in 12 equal monthly installments, beginning September 1, 2010.

The CEA recorded the \$5,470,000 capital contribution as a receivable and as an increase to contributed surplus on the balance sheet. As of December 31, 2010, the CEA had received five installments from State Farm, reducing the remaining receivable balance to \$3,190,830.

#### CEA HISTORY

The CEA was created in 1996 pursuant to California Insurance Code (CIC) Section 10089.6 to transact insurance in California as necessary to sell policies of basic residential earthquake insurance in the manner set forth in CIC Sections 10089.26 through 10089.28, and commenced operations in December 1996.

#### MANAGEMENT AND CONTROL

Pursuant to California Insurance Code (CIC) Section 10089.7(a), the CEA is governed by a three-member Governing Board consisting of the Governor, the State Treasurer, and the Insurance Commissioner, each of whom may name designees to serve as board members in their place. The Speaker of the Assembly and the Chairperson of the Senate Rules Committee serve as nonvoting, ex officio members of the Governing Board, and may name designees to serve in their place.

CIC Section 10089.7(c) provides that the Governing Board shall have the power to conduct the affairs of the CEA, and may perform all acts necessary or convenient in the exercise of that power.

A listing of the members of the Governing Board and principal officers serving on December 31, 2009 follows:

Governing Board

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Arnold Schwarzenegger Los Angeles, California	Governor State of California
Bill Lockyer Hayward, California	Treasurer State of California
Steve Poizner Los Gatos, California	Insurance Commissioner State of California
Karen Bass* Los Angeles, California	Speaker of the Assembly State of California
Darrel Steinberg* Sacramento, California	Chairman of the Senate Rules Committee State of California

*\*Non-voting members*

Principal Officers

<u>Name</u>	<u>Position</u>
Glenn Pomeroy	Chief Executive Officer
Timothy Richison	Chief Financial Officer
Robert Stewart	Chief Operations Officer

Management Agreements

Services are performed on behalf of the CEA by the participating insurers pursuant to the terms of the Participating Insurer Agreements signed by the CEA and each participating insurer. These services include policy administration and claims settlement. Refer to the section "TERRITORY AND PLAN OF OPERATION" for more information on the participating insurers.

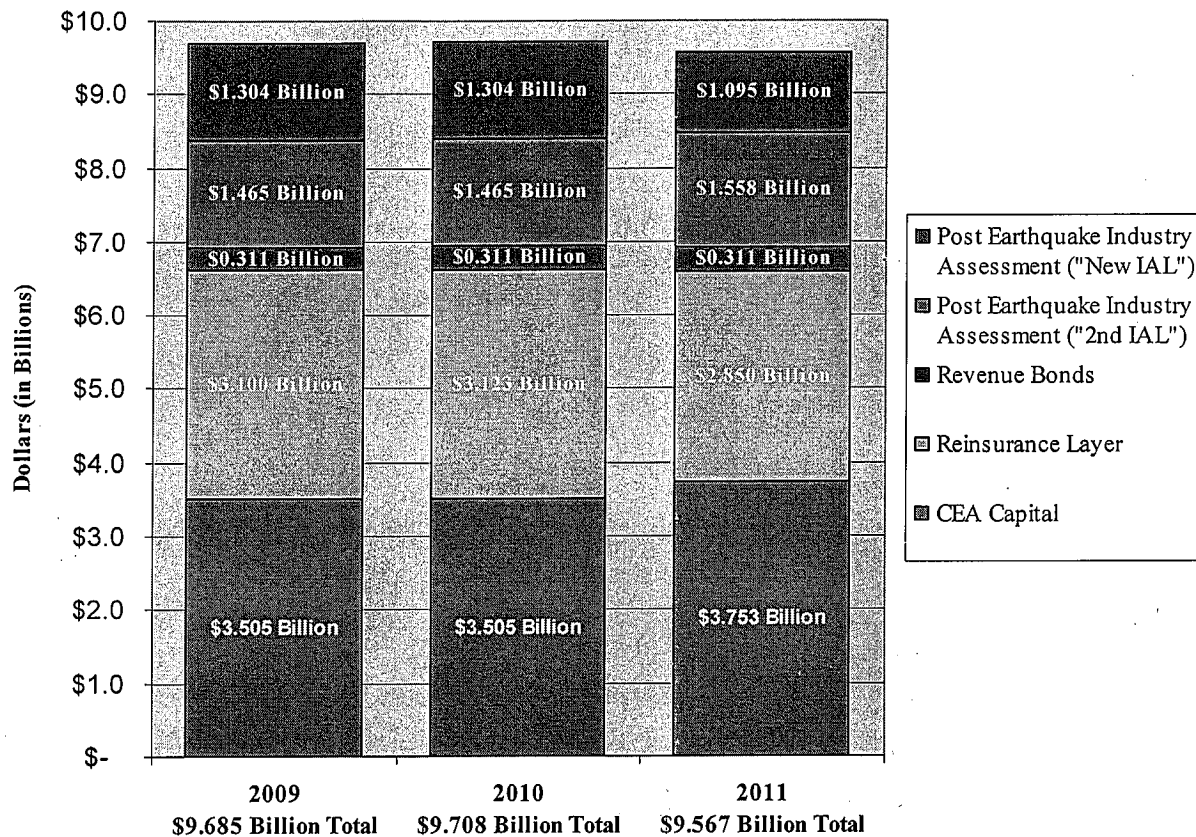
## CLAIMS PAYING CAPACITY

As of December 31, 2009 the CEA had a claims paying capacity of \$9.685 billion. The CEA's claims paying capacity comes from CEA's available capital (\$3.505 billion), reinsurance coverage (\$3.1 billion), revenue bonds (\$0.311 billion), post-earthquake industry assessments under California Insurance Code (CIC) Section 10089.30 (\$1.465 billion), and post-earthquake industry assessments under CIC Section 10089.31 (\$1.304 billion).

On January 1, 2010, the CEA's claims paying capacity increased to \$9.708 billion due to an increase in projected losses to maintain a 1-in-500 year event financial security level. On January 1, 2011, the CEA's claims paying capacity was reduced to \$9.567 billion. The reduction was due to a decrease in reinsurance coverage from \$3.123 billion to \$2.85 billion as a result of a decrease in projected losses to maintain a 1-in-500 year financial event security level as well as a decrease in the available post-earthquake industry assessment under CIC Section 10089.31 from \$1.304 billion to \$1.095 billion. A chart illustrating the sources of the claims paying capacity for 2009, 2010, and 2011 is shown below:



### Claims Paying Capacity for 2009, 2010 & 2011



### TERRITORY AND PLAN OF OPERATION

Pursuant to California Insurance Code (CIC) Section 10089.6(a), the CEA is only authorized to write basic residential earthquake insurance in the State of California. Earthquake insurance policies are available for residential property owners, condominium owners, mobile homeowners, and renters in California.

The CEA offers two types of earthquake insurance coverage: primary coverage and supplemental coverage. The primary coverage (or "mini-policy") is the CEA's main product and has been available since the CEA began operations in 1996. It includes coverage on the dwelling building (dwelling coverage limits matches the dwelling coverage limits on the underlying homeowner's

or mobile homeowner's policy) with a 15% deductible (no coverage on appurtenant structures), a \$5,000 coverage limit on contents (the 15% dwelling loss triggers this benefit) and a \$1,500 coverage limit on loss of use with no deductible. The renter policy has a \$5,000 coverage limit on contents with a 15% deductible and a \$1,500 coverage limit on loss of use with no deductible. The condominium policy has a \$25,000 coverage limit on building property with a 15% deductible, a \$5,000 coverage limit on contents with a 15% deductible, and a \$1,500 coverage limit on loss of use with no deductible. In each case the policy covers primary damage from the earthquake itself but excludes any benefits for damage from fire caused by the earthquake.

The supplemental options available to homeowners and mobile home owners are lower deductibles on dwelling coverage (reduced to 10%), higher limits on contents (up to \$100,000), and on loss of use (up to \$15,000). Supplemental options available to condominium owners and renters are higher limits on contents (up to \$100,000), and on loss of use (up to \$15,000). In addition, condominium owners may purchase optional coverage for loss assessment (up to \$75,000).

CEA's earthquake business is placed through its participating insurers. Pursuant to CIC Section 10089.9, each insurer participating in the CEA shall execute a contract with the Commissioner that sets forth its rights and responsibilities as a CEA participant, and such contract shall be part of the CEA's plan of operations and shall be uniform for every participating insurer. Insurers participating in the CEA represent approximately 67 percent of California's residential property insurance market. As of the examination date, there were 20 insurers participating in the CEA of which 15 were writing CEA policies.

Participating insurers receive a producer commission equal to 10 percent of written premium for all new and renewal CEA policies and an operating cost reimbursement equal to 6 percent of gross written CEA premiums.

The CEA imposes an eligibility requirement for earthquake policies as follows: (1) The risk must be a qualified residential property; (2) The risk must be insured by a companion policy issued by a CEA participating insurer that will act as the servicing carrier for the earthquake policy; (3)

The risk must be insured to the value of the companion policy; and (4) All prior earthquake structural damage must be repaired before an application for coverage is accepted.

The following table is the direct premiums written during the examination period:

<u>Year</u>	<u>Written Premiums</u>
2009	\$607,676,744
2008	521,509,899
2007	498,476,831
2006	501,357,097
2005	503,357,794

Pursuant to CIC Section 10089.6(c), the CEA's operating expenses shall be capped at not more than 3 percent of the premium income received by the CEA.

#### Credit Facilities

CIC Section 10089.50 states that the State Treasurer may from time to time enter into one or more credit facilities permitting the CEA to draw an amount up to \$1 billion with payment, interest rate, indemnity, compensation, security, default, remedy, and other terms and conditions as determined by the CEA. All drawings of these credit facilities shall be available as funding for the CEA as provided in CIC Section 10089.29. Pursuant to CIC Section 10089.51, the CEA shall have the power to pledge to the providers of credit facilities, and to the owners of bonds, the surcharges imposed or to be imposed pursuant to CIC Section 10089.29(b) to secure payment of all obligations of the CEA under those credit facilities and bonds. CIC Section 10089.23(a) (3) states in part that the maximum permissible bond issuances or other debt financing issued, or secured by the Treasurer pursuant to CIC Section 10089.29 shall be reduced uniformly by the multiplication of the maximum assessments and other amounts provided in this section by the percentage of the total residential property insurance market share participation attained by the CEA upon its commencement. The CEA did not enter into any credit facility under this Section as of December 31, 2009.

### Revenue Bonds or Other Debt Financing

CIC Section 10089.10(b) states that the CEA, through the Treasurer, shall enter capital market contracts on terms as the board and Treasurer may consider reasonable and appropriate. CIC Section 10089.10(c) states in part that the total annual expenditure for capital market contracts pursuant to this section shall not exceed a reasonable and appropriate percentage of the annual earthquake insurance premiums collected by the authority. In 2006, the CEA issued \$315 million in revenue bonds pursuant to CIC Section 10089.10, of which \$220.5 million in principal was outstanding as of December 31, 2009.

CIC Section 10089.29 states that if benefits paid by the CEA following any earthquake event exhaust the total of (1) the CEA's available capital, (2) the maximum amount of all insurer capital contributions and assessments pursuant to CIC Sections 10089.15 and 10089.23, (3) all reinsurance actually available under contract to the CEA, and (4) all capital committed and actually available by contract to the CEA from private capital markets, the State Treasurer, as agent for sale of bonds for the CEA, may sell investment grade revenue bonds, or issue or secure other debt financing in an amount up to \$1 billion, as determined by the board. The State Treasurer shall make available the net proceeds of the revenue bonds or debt financing as funding for the CEA. The State Treasurer may sell revenue bonds for the purpose of refunding the revenue bonds or other debt financing when authorized to do so by the board, and the surcharge authorized by this Section may be used to repay the refunding.

In the event of a revenue bond sale or debt financing arrangement pursuant to CIC Section 10089.29, the CEA shall have the power annually to surcharge all CEA policies to secure funds solely to repay the bonded indebtedness or other debt. The net surcharge may in no event exceed \$1 billion, plus costs of issuance and sale of those revenue bonds or other debt and amounts paid or payable to bond issuers and providers of credit support and letters of credit for and interest on those revenue bonds and other debt. In no event shall the surcharge on any CEA policy exceed 20 percent of the annual basic residential earthquake insurance premium in any one year for the policy. CIC Section 10089.29(d) states that the CEA shall cancel the policy of basic residential earthquake insurance if the policyholder fails to pay the earthquake policy surcharge authorized

by the CEA, and the insurer shall cancel the policy of residential property insurance if the policyholder fails to pay the policy surcharge authorized by the CEA. The CEA has issued no debt subject to CIC Section 10089.29 as of the examination date.

#### Post Earthquake Industry Assessments

CIC Section 10089.23 provides that if at any time following the payment of earthquake losses, the CEA's available capital is reduced to less than \$350 million, or if at any time the CEA's available capital is insufficient to pay benefits and continue operations, the CEA shall have the power to assess participating insurance companies. The assessment shall be limited to the amount necessary to pay the outstanding and expected claims of the CEA and to return the CEA's available capital to \$350 million, as determined by the Governing Board, subject to approval by the Commissioner. Each participating insurer's assessment shall be determined by multiplying its residential earthquake insurance market share as of April 30th of the immediately preceding year, or the most recent year for which premium data not more than one year old is available, by the amount of the total assessment sought by the CEA. The total of all assessments levied by the CEA pursuant to this Section shall not exceed \$3 billion, regardless of the frequency or severity of earthquake losses at any and all times subsequent to the creation of the CEA. Once a participating insurer has paid amounts equal to its residential insurance market share multiplied by \$3 billion, the CEA's power to assess that insurer under this Section shall cease, and the CEA shall be prohibited from levying additional assessments on that insurer pursuant to this Section. The participating insurer assessments under this Section expired on December 1, 2008.

CIC Section 10089.30 provides that if benefits paid by the CEA due to earthquake events exhaust the total of (a) the CEA's available capital; (b) the maximum amount of all insurer contributions and assessments pursuant to CIC Sections 10089.15 and 10089.23; (c) all reinsurance actually available and under contract to the CEA; (d) the maximum amount of all policyholder assessments pursuant to CIC Section 10089.29; and (e) all capital committed and actually available from the private capital markets, the Governing Board, subject to the approval of the Commissioner, shall have the power to assess participating insurance companies. The

total amount of all assessments levied against participating insurance companies by the CEA pursuant to this Section, shall not exceed \$2 billion, regardless of the frequency or severity of earthquake losses at any and all times subsequent to the creation of the CEA. Once a participating insurer has paid amounts equal to its residential earthquake insurance market share multiplied by \$2 billion, pursuant to this Section, the CEA's power to assess that insurer under this Section shall cease and the CEA shall be prohibited from levying additional assessments on that insurer pursuant to this Section. The Governing Board shall make the assessment pursuant to this Section in proportion to each participating insurer's residential earthquake market share. The assessment shall be limited to the amount necessary to pay the expected claims of the CEA and return the CEA's available capital to \$350 million, as determined by the Governing Board, subject to the approval by the Commissioner.

CIC Section 10089.31 provides that if claims and claim expenses paid by the CEA due to earthquake events that commence on or after December 1, 2008, exhaust the total of all (a) the CEA's available capital, (b) the maximum amount of all insurer capital contributions and assessments pursuant to CIC Sections 10089.15, 10089.23, and 10089.30, (c) all reinsurance actually available and under contract to the CEA, (d) the maximum amount of all CEA policyholder assessments pursuant to CIC Section 10089.29, and (e) all capital committed and actually available from the private capital markets, the Governing Board, beginning December 1, 2008, for earthquake events commencing on or after December 1, 2008, shall have the power to assess participating insurance companies subject to the maximum limits in this section. Each participating insurer's assessment shall be determined by multiplying the percentage share of the CEA's total gross written premium attributable to that participating insurer's sales of CEA insurance policies as of April 30 of the immediately preceding year, or the most recent year for which premium data not more than one year old are available, by the amount of the total assessment sought by the CEA. The total amount of all assessments levied against participating insurance companies by the CEA pursuant to this Section shall not exceed \$1.78 billion, regardless of the frequency or severity of earthquake losses at any and all times subsequent to the creation of the CEA. Once a participating insurer has paid pursuant to this section amounts equal to its percentage share of the CEA's total gross written premium, multiplied by \$1.78 billion reduced as provided in paragraph (3) of subdivision (a) of Section

10089.23 from the maximum assessment, which is to be reduced periodically pursuant to subdivision (b) of Section 10089.33, or upon the earlier occurrence of the effective date stated in paragraph (6) of subdivision (b) of Section 10089.33, the CEA's power to assess that insurer under this section shall cease and the CEA shall be prohibited from levying additional assessments on that insurer pursuant to this section. The assessment shall be limited to the amount necessary to pay the expected claims and claim expenses of the CEA and return the CEA's available capital to \$350 million, as determined by the Governing Board.

CIC Section 10089.33 states that if the average daily balance of the CEA's available capital exceeds \$6 billion, for the last 180 days of any calendar year, the Governing Board shall relieve all participating insurers of their obligation to pay additional earthquake assessment under Section 10089.30 by an amount equal to the amount of available capital in excess of \$6 billion. Each December 31st thereafter, the Governing Board shall further reduce the aggregate assessment authorized by this Section by the net increase in available capital in excess of the previous level of available capital at which the reduction in the aggregate assessment was made. No reduction pursuant to this subdivision shall exceed 15 percent of the original aggregate assessment in any year of operation of the CEA. In no event shall any reduction previously authorized by the Governing Board be reinstated.

CIC Section 10089.33(b) further provides that commencing April 1, 2010, and on each April 1 thereafter, the Governing Board shall reduce the combined assessment obligation of all participating insurers under CIC Section 10089.31 by 5 percent of the maximum aggregate authorized as of January 1, 2009, and by the "retained earnings differential" meaning the positive dollar-amount difference between the CEA's one-year retained-earnings growth for the preceding calendar year minus the CEA's capacity growth for the preceding calendar year, both calculated as of December 31. If, however, the CEA establishes reserves for claims and claims expenses, including losses incurred but not reported, in the aggregate exceeding \$500 million on account of a single earthquake, then the preceding calendar year will not constitute a Section 10089.31 assessment-reduction year. In addition, no more than two annual periods may be deemed not to constitute an assessment-reduction year.

### Claims in Excess of Available Capital

CIC Section 10089.35 states that if at any time the Governing Board determines that all of the CEA's available capital may be exhausted and no source of additional funds such as assessments, reinsurance or private capital market moneys will be available to the CEA to pay policyholder claims, the Governing Board shall draw up and present to the Commissioner a plan to pay policyholder claims on a pro rata basis or in installment payments. The Governing Board shall maintain sufficient capital to ensure the continued operations of the CEA for the purpose of implementing the proration or installment plan. At this point, the Commissioner shall adopt a schedule for restitution of an insurer's statutory obligation to offer earthquake insurance by a means other than the placement in the CEA. In no event shall the schedule adopted pursuant to this subdivision be for a period longer than six months.

### California Insurance Guarantee Association Coverage and Assessments

CIC Section 10089.34 provides that policies issued by the CEA shall not be subject to assessment for, nor shall any CEA policyholder be eligible for benefits from the California Insurance Guarantee Association.

### Earthquake Loss Mitigation Fund

CIC Section 10089.37 states that the Governing Board shall set aside in each calendar year an amount equal to 5 percent of investment income accruing to the CEA's invested funds, or \$5 million, whichever is less, if deemed actuarially sound by a consulting actuary employed for, or hired by the CEA, to be maintained as a sub-account in the California Earthquake Authority Fund. The CEA shall use those funds to fund the establishment and operation of an Earthquake Loss Mitigation Fund. CIC Section 10089.38 states that the Earthquake Loss Mitigation Fund may be applied by supply grants and loans or loan guarantees to dwelling owners who wish to retrofit their homes to protect against earthquake losses.



### Cessation of Writing

CIC Section 10089.54 states that unless authorized by a statute enacted subsequent to the effective date of this Section, the CEA shall cease writing new earthquake insurance policies 180 days after implementation by both the Federal National Mortgage Association and the Federal Home Loan Mortgage Association of policies to require earthquake insurance for any single-family residential structure other than a condominium unit of town home as a condition of purchasing as mortgage or trust deed secured by that structure. It is the intent of the Legislature that in that event it should convene to consider whether the CEA should continue to write new earthquake insurance policies, with or without modification, or to cease writing new earthquake insurance policies.

### REINSURANCE

#### Assumed

The CEA has no reinsurance assumed.

#### Ceded

The following table is an outline of the CEA's ceded reinsurance program as of December 31, 2009:

<u>Type of Contract</u>	<u>Reinsurer(s)</u>	<u>CEA's Retention</u>	<u>Reinsurer's Maximum Limit</u>
Contract #1 Excess of Loss	Various authorized and unauthorized reinsurers	\$3.5 billion aggregate incurred ultimate net loss	\$500 million excess of \$3.5 billion aggregate incurred ultimate net loss
Contract #2 Excess of Loss	Various authorized and unauthorized reinsurers	\$4 billion aggregate incurred ultimate net loss	\$500 million excess of \$4 billion aggregate incurred ultimate net loss
Contract #3 Excess of Loss	Various authorized and unauthorized reinsurers	\$4.5 billion aggregate incurred ultimate net loss	\$200 million excess of \$4.5 billion aggregate incurred ultimate net loss
Contract #4 Excess of Loss	Various authorized and unauthorized reinsurers	\$4.7 billion aggregate incurred ultimate net loss	\$100 million excess of \$4.7 billion aggregate incurred ultimate net loss

<u>Type of Contract</u>	<u>Reinsurer(s)</u>	<u>CEA's Retention</u>	<u>Reinsurer's Maximum Limit</u>
Contract #5 Excess of Loss	Various authorized and unauthorized reinsurers	\$4.8 billion aggregate incurred ultimate net loss	\$200 million excess of \$4.8 billion aggregate incurred ultimate net loss
Contract #6 Excess of Loss	Various authorized and unauthorized reinsurers	\$5 billion aggregate incurred ultimate net loss	\$200 million excess of \$5 billion aggregate incurred ultimate net loss
Contract #7 Excess of Loss	Various authorized and unauthorized reinsurers	\$5.160 billion aggregate incurred ultimate net loss	\$250 million excess of \$5.160 billion aggregate incurred ultimate net loss
Contract #8 Excess of Loss	Various authorized and unauthorized reinsurers	\$5.41 billion aggregate incurred ultimate net loss	\$650 million excess of \$5.41 billion aggregate incurred ultimate net loss
Contract #9 Excess of Loss	Various authorized and unauthorized reinsurers	\$6 billion aggregate incurred ultimate net loss <sup>(a)</sup>	\$400 million excess of \$6 billion aggregate incurred ultimate net loss <sup>(a)</sup>
Contract #10 Excess of Loss	Various authorized and unauthorized reinsurers	\$6 billion aggregate incurred ultimate net loss <sup>(b)</sup>	\$400 million excess of \$6 billion aggregate incurred ultimate net loss <sup>(b)</sup>
Contract #11 Excess of Loss	Various authorized and unauthorized reinsurers	\$6.060 billion aggregate incurred ultimate net loss	\$100 million excess of \$6.060 billion aggregate incurred ultimate net loss

<sup>(a)</sup> In addition to the retention, the CEA may choose to retain a percentage share equal to 37.5% of \$400 million in aggregate incurred ultimate net losses exceeding its retention under this contract. In this event, the reinsurers' percentage share will be 62.5% of \$400 million in aggregate incurred ultimate net losses in excess of \$6 billion.

<sup>(b)</sup> In addition to the retention, the CEA may choose to retain a percentage share equal to 62.5% of \$400 million in aggregate incurred ultimate net losses exceeding its retention under this contract. In this event, the reinsurers' percentage share will be 37.5% of \$400 million in aggregate incurred ultimate net losses in excess of \$6 billion.

The California Code of Regulations, Title 10, Chapter 5, Subchapter 7.7, Section 2697.61 was amended in 2008 to permit the integration of the optional-limits program (supplemental earthquake coverage) with the base-limits program (basic earthquake policies). This integration renders the former maintenance of separate funds for each program within the CEA unnecessary and inappropriate and permitted reinsurance coverage for the basic earthquake policies and supplemental earthquake coverage to be combined.

## FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2009

Underwriting and Investment Exhibit for the Year Ended December 31, 2009

Reconciliation of Surplus as Regards Policyholders from December 31, 2004 through  
December 31, 2009

Statement of Financial Condition  
as of December 31, 2009

	<u>Ledger and Non-ledger Assets</u>	<u>Non- Admitted Assets</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
<u>Assets</u>				
Bonds	\$2,118,616,467	\$	\$2,118,616,467	
Cash and short-term investments	1,835,406,317		1,835,406,317	
Investment income due & accrued	20,543,245		20,543,245	
Premiums and agents' balances:				
in course of collection	54,495,515	10,183,903	44,311,612	(1)
Electronic data processing equipment and software	1,502,899		1,502,899	
Furniture and equipment	37,253	37,253	0	
Aggregate write-ins for other than invested assets	<u>491,338</u>	<u>169,355</u>	<u>321,983</u>	
Total assets	<u>\$4,031,093,034</u>	<u>\$ 10,390,511</u>	<u>\$4,020,702,523</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 0	(2)
Loss adjustment expenses			0	(2)
Other expenses			1,702,036	
Borrowed money			227,301,323	(3)
Unearned premiums			293,406,161	
Advance premiums			<u>0</u>	(4)
Total liabilities			\$ 522,409,520	
Aggregate write-ins for special surplus funds		\$ (30,121,575)		
Gross paid in and contributed surplus		751,152,246		
Unassigned funds		<u>2,777,262,332</u>		
Surplus as regards policyholders			<u>3,498,293,003</u>	
Total liabilities, surplus and other funds			<u>\$4,020,702,523</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2009

Statement of Income

Notes

Underwriting Income

Premiums earned		\$ 395,257,060
Deductions:		
Losses incurred	\$ 126,273	
Loss expenses incurred	11,365	
Other underwriting expenses incurred	<u>110,751,294</u>	
Total underwriting deductions		<u>110,888,932</u>
Net underwriting gain		284,368,128

Investment Income

Net investment income earned	\$ 53,780,427	
Net realized capital loss	<u>10,129</u>	
Net investment gain		53,790,556

Other Income

Net loss from agents' or premium balances charged off	\$ (7,536,942)	(1)
Finance and service charges included not included in premiums	<u>395,700</u>	
Total other income		<u>(7,141,242)</u>
Net income		<u>\$ 331,017,442</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2008		\$3,172,013,476
Net income	\$ 331,017,442	
Change in nonadmitted assets	(8,039,842)	
Aggregate write-ins for gains and losses in surplus	<u>3,301,927</u>	(1)(5)(6)
Change in surplus as regards policyholders for the year		<u>326,279,527</u>
Surplus as regards policyholders, December 31, 2009		<u>\$3,498,293,003</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2004 through December 31, 2009

Notes

Surplus as regards policyholders, December 31, 2004, per Examination \$1,820,817,750

	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$1,650,763,437	\$ .0	
Change in nonadmitted assets		7,430,855	
Change in provision for reinsurance	8,412,000		
Surplus adjustments	46,500,000		(7)
Aggregate write-ins for gains and losses in surplus	<u>                    </u>	<u>20,769,328</u>	
Totals	<u>\$1,705,675,437</u>	<u>\$ 28,200,184</u>	

Net increase in surplus as regards policyholders for the examination period 1,677,475,253

Surplus as regards policyholders, December 31, 2009, per Examination \$3,498,293,003

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Premiums and Agents' Balances in Course of Collection

The CEA is not in compliance with Statement of Statutory Accounting Principles (SSAP) No. 6, paragraph 7, because it does not follow the guidance when aging premiums for the purpose of nonadmitting amounts over 90 days due. The CEA's current practice is to age the premium receivable from the last date that a payment was received on the policy. SSAP No. 6, paragraph 7, requires the aging to be computed from the due date, which is defined as the policy effective date for original and deposit premiums and from the contractual due date for installment premiums. No exam adjustment was made for this finding because the amount involved is not material. It is recommended that the CEA comply with SSAP No. 6, paragraph 7.

The CEA's accounting for uncollectible premiums and agents' balances charged off is not in compliance with SSAP No. 6, paragraph 10. For the period ended December 31, 2009, the CEA reported a net loss from premiums and agents' balances charged off of \$7,536,942. However, this amount consists of the change in nonadmitted premiums and agents' balances over 90 days due only and does not include any premiums or agents' balances that were actually written off. SSAP No. 6, paragraph 10, requires that any uncollectible receivable be written off and charged to income in the period the determination is made. The change in nonadmitted agents' and premium balances over 90 days due is already included in the "Change in nonadmitted assets" line under the "Capital and Surplus Account" section of the Statement of Income and accounting for this amount as a "net loss from agents' or premium balances charged off" is unnecessary. In addition, the amount that is charged off should not be added back to policyholders' surplus through the "Aggregate write-in for gains and losses in surplus" line under the "Capital and Surplus Account" section of the Statement of Income. Any amounts that are written off should be charged to income in the period the determination is made in accordance with SSAP No. 6, paragraph 10. No examination adjustment was made because the amount involved is not material. It is recommended that the CEA comply with SSAP No. 6, paragraph 10.

## (2) Losses and Loss Adjustment Expenses

The CEA writes only residential earthquake insurance, which has a fast reporting and payment development period. During the examination period, the CEA's net paid losses and loss adjustment expenses were less than \$200,000. Net paid losses and loss adjustment expenses since the CEA's inception were approximately \$3.7 million. No major earthquakes have occurred in CEA's territories during the examination period that resulted in material insured losses. As a result, no outstanding loss and loss adjustment expense reserves were reported as of December 31, 2009.

An analysis of the CEA's financial modeling process was performed with the assistance of a Casualty Actuary from the California Department of Insurance (CDI) during this examination. The analysis looked at 1) the data quality and completeness of the CEA's exposure data, 2) the appropriateness of the CEA's use of commercial catastrophe models in monitoring and managing its exposure, and 3) the ability of the CEA to maintain its capital structure going forward. The CDI concurs that the CEA's claims paying capacity at December 31, 2009 of \$9.685 billion and its estimated claims paying capacity as of January 1, 2011 of \$9.567 billion are sufficient to cover CEA's losses from a 1-in-500 year earthquake event. However, there are concerns as to whether or not the CEA would be able to recapitalize once the bottom layer of the retained capital is exhausted. It is observed that the CEA's retained capital would be exhausted by the modeled 1-in-100 year event of \$4.1 billion (a somewhat more likely scenario than the 1-in-500 year event the CEA uses as a benchmark for solvency assessment). It is recommended that management develop a mechanism for recapitalizing the CEA.

## (3) Borrowed Money

Under authority granted by California Insurance Code (CIC) Section 10089.10 and with the approval of the Governing Board, the CEA issued \$315 million in revenue bonds on July 20, 2006. The California Earthquake Authority 2006 Series revenue bonds carry a fixed coupon rate of 6.169% and mature on July 1, 2016 with 10 percent of the original principal amount being redeemed each year. Per the bond indenture, proceeds from the revenue bond sale



can be used for future payments of earthquake claims only, and may only be used after the CEA exhausts its available capital, all insurer assessments pursuant to CIC Section 10089.23, and all reinsurance actually available and under contract to the CEA.

(4) Advance Premiums

The CEA is not in compliance with SSAP No. 53, paragraph 13, because it did not report an advance premium liability for \$1,351,563 in premiums it had collected at December 31, 2009 for policies with effective dates in 2010. No examination adjustment was made because the amount involved is not material. It is recommended that the CEA comply with SSAP No. 53, paragraph 13.

(5) Loss Mitigation Fund Liability

CIC Section 10089.37 requires the CEA to set aside in each calendar year an amount equal to 5 percent of investment income accruing to the CEA's invested funds, or \$5 million, whichever is less, to be maintained as a subaccount in the California Earthquake Authority Fund (Loss Mitigation Fund).

Typically, funding for the CEA Loss Mitigation Fund occurs subsequent to year end because the law requires the CEA's actuary to opine on whether the transfer will impair the actuarial soundness of the CEA. Since the actuary cannot opine on the soundness of funding the Loss Mitigation Fund until the CEA's audited financial statements are available (which usually occurs months after the end of the year), no funds were set aside as of December 31, 2009 pursuant to CIC Section 10089.37. The CEA's Loss Mitigation Fund obligation for calendar year 2009 was \$2,772,498 based on 2009 investment income and it was observed that the CEA did not accrue a liability for this expense as of December 31, 2009. The CEA's Loss Mitigation Fund obligation meets the definition of a liability as defined under SSAP No. 5, paragraphs 2 through 4. As such, it is recommended that the CEA accrue a liability at year end for its Loss Mitigation Fund obligation under CIC Section 10089.37. No examination adjustment was made because the amount involved is not material.

(6) Pro Forma Premium Taxes

CIC Section 10089.44 provides that premiums collected by the CEA are exempt from California premium taxes and the amount of taxes foregone by the state are considered for all purposes a contribution by the state and its citizens to the capital and operating revenues of the CEA. It was observed that these pro forma premium taxes are reported in the CEA's GAAP financial statements, but are not reported in the CEA's statutory financial statements. In addition, it was observed that the CEA does not use direct premiums written as reported in its statutory Annual Statement Schedule T, line 5, column 2, and does not include installment fees in the taxable premium amount as instructed in the California premium tax filing instructions when computing the pro forma premium taxes. No examination adjustment was made because there is no impact to the CEA's policyholders' surplus. It is recommended that the CEA follow the California premium tax filing instructions when computing the pro forma premium taxes and report the pro forma premium taxes in its statutory financial statements.

(7) Surplus Adjustments

The surplus adjustments of \$46.5 million represent the capital contribution from Safeco Insurance Company of America (Safeco) when Safeco became a CEA participating insurer effective July 1, 2008.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Comments on Financial Statement Items – Premiums and Agents' Balances in Course of Collection (Page 21): It is recommended that the CEA comply with Statement of Statutory Accounting Principles (SSAP) No. 6, paragraphs 7 and 10.

Comments on Financial Statement Items – Loss and Loss Adjustment Expenses (Page 22): It is recommended that management develop a mechanism for recapitalizing the CEA.

Comments on Financial Statement Items – Advance Premiums (Page 23): It is recommended that the CEA comply with SSAP No. 53, paragraph 13.

Comments on Financial Statement Items – Loss Mitigation Fund Liability (Page 23): It is recommended that the CEA accrue a liability at year end for its Loss Mitigation Fund obligation under California Insurance Code (CIC) Section 10089.37.

Comments on Financial Statement Items – Pro Forma Premium Taxes (Page 24): It is recommended that the CEA follow the California premium tax filing instructions when computing the pro forma premium taxes pursuant to CIC Section 10089.44 and report the pro forma premium taxes in its statutory financial statements.

#### Prior Report of Examination

Territory and Plan of Operations – Earthquake Loss Mitigation Fund (Page 11): It was recommended that the amounts required under CIC Section 10089.37 be set aside in each calendar year. The CEA has complied with CIC Section 10089.37.

## ACKNOWLEDGEMENT

Acknowledgment is made of the cooperation and assistance extended by the CEA's officers and employees during the course of this examination.

Respectfully submitted,

/S/

Ber Vang, CFE, AES, CISA  
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